

Robert P. Dowski
Chief Financial Officer
Allied Defense Group (ADG)

Testimony
Before the Committee on Government Reforms, Subcommittee on Regulatory Affairs
United States House of Representatives

Hearing on the Securities and Exchange Commission's (SEC) implementation of the
Sarbanes Oxley Act

Good morning Chairman Miller and members of the subcommittee. My name is Robert Dowski and I am Chief Financial Officer of the Allied Defense Group – also known as ADG. It's an honor for me to be here before the Committee on Government Reform representing ADG, its management team and Board of Directors.

ADG is a small public company. We are headquartered in Vienna, Virginia and have 7 operating units located overseas in Belgium and here in Texas and California. We design and manufacture medium caliber ammunition and products for the security, surveillance and video transmission markets. We have approximately 700 employees and in 2005 produced approximately 110M\$ in revenues. Our largest operating unit produced 60M\$ of revenue and our smallest produced 6M\$. We uncharacteristically lost over 20M\$ on the bottom line in 2005. 2005 was also the second year of our SOX implementation.

I must be honest, Chairwoman Miller - and tell you that not all of that loss was not attributable to our SOX compliance efforts – but – like many other companies in the United States – we spent a great deal of time and effort trying to meet a set of one size fits all regulations that did not – as enacted and thereafter interpreted – adequately differentiate between a company the size of ADG or IBM

I come before the committee as a believer in the primary goals of the Sarbanes-Oxley legislation: Providing more timely, accurate and transparent information for investors. ADG believes a well run company should have and maintain good internal controls. As a company, working hand in hand with our public auditors – we have made significant progress in improving our internal controls – and we will continue on that journey in 2006 and beyond.

But it has come at a cost. In 2005 we spent over 1.8M\$ on external fees for SOX compliance and auditing. We spent that much and probably more on internal resources on documentation, testing and related activities. That 3.6M\$ equates to over \$0.62 per share of negative earnings for our shareholders – not to mention the unmeasured opportunity costs of efforts not spent on improving revenue, profit and productivity within the company.

Robert Greifeld – President and CEO of Nasdaq in a recent Wall Street Journal editorial summarized the situation very well – “the burden of compliance is onerous, the cost is significant, and it falls disproportionately on smaller companies that are least able to pay. Our research has shown that the burden on small companies, on a percentage of revenue basis, is 11 times that of a large company.”

He went on to say that “SOX is important, by in large it works. We have had three years to assess its strengths and problems. Perhaps 90% of all complaints have their genesis in 20 lines of text in Section 404. The time has come to address those 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Specifically we should adopt the recommendations of the SEC's Advisory Committee on Smaller Public Companies, which has proposed an exemption from 404 for companies with less than 128M\$ in market cap and revenues under 125M\$. Companies with up to 787M\$ in

market cap, as long as they had revenues of less than 250M\$, – would receive a partial exemption. The companies exempted account for only 6% of the US market cap – which means 404 would still apply fully to 94% of equity market capitalization.”

ADG agrees with Mr Greifeld’s observations and supports his call for reform and exemptions.

In their discussion on cost/benefit, the Committee of Sponsoring Organizations (COSO) states that: “The challenge under 404 is to find the right balance. Excessive control is costly and counterproductive”. ADG believes that auditors should not have a one size fits all checklist when auditing companies of very different sizes, and regulators should amend the current rules to accommodate the special needs and circumstances faced by smaller companies.

In smaller companies such as ADG the simple lack of people can be a liability. For example: it can be more difficult to achieve separation of duties – that 404 calls for in many areas - because of flatter organizations and smaller staffs. We have some operating units that have less than 40 people. Workers and managers at those units typically have multiple roles and responsibilities – so you have a higher dependence on people doing the right thing. You also typically have a higher degree of direct and explicit knowledge of day to day activities – since the managers are much closer to daily transactions than their peers at bigger companies and yet there is no recognition in the standards for that inner transparency. Managers and executives should be allowed to place more reliance on monitoring than control activities under those circumstances.

The existing paradigm of documentation and testing creates huge burdens in small companies. Controls that exist but are not properly documented and tested internally are not considered by the auditors in their assessments. Off setting informal controls that are ingrained into the culture of smaller companies do not receive any credit in the existing evaluation process. We agree with COSO that internal control should be a process designed to provide reasonable assurance regarding the reliability of financial reporting. But we also agree with the rule of thumb for internal controls that benefits should outweigh the costs. The current construct of Section 404 does not meet that criteria. If employees are spending excessive hours on fine tuning internal controls, updating documentation, testing controls, evaluating and re-evaluating financial reports and compiling more extensive information for their board of directors – other more important activities – like growing revenues, improving margins and increasing shareholder value will suffer.

ADG agrees that the time has come to address 404 concerns without diluting the essential investor protections that are the true legacy of SOX. Proposals for exemptions for smaller companies should be considered. We should reexamine the standards for defining and measuring internal controls at large, medium and small companies. It makes no sense to have one set of standards that apply equally to IBM and ADG.

The Public Company Accounting Oversight Board (PCAOB) should spend more time and energy providing guidance for interpreting reasonable standards under Section 404 and less effort assessing liability and sanctions on public auditing companies. The goal should be for external auditors to conduct streamlined, cost effective examinations of internal controls and the accuracy of financial reporting. Auditors should once again be a resource for the company in arriving at the right answers to ensure accuracy and transparency.

Auditors don't commit fraud - dishonest people inside companies do. Congress should increase the civil and criminal penalties on those people who violate the trust of shareholders. Violators should forfeit all of their assets and spend years in jail. When people who have defrauded investors and fellow employees out of billion of dollars are allowed to keep their fancy homes and other off shore assets – then how on earth does the punishment fit the crime?

People with high ethical standards are the best defense of the public interest.

Thank you for this opportunity to present my views before the committee. I hope my comments have made some small contribution to your efforts to evaluate the effectiveness of Section 404. I would be happy to answer any questions you might have.